

THE ECONOMIC SITUATION

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June 1, 2014

- **Look for a better second half.**
- **What will the policy makers do? Does it matter?**
- **What about inflation and higher interest rates?**
- **Regulation's economic imprint.**
- **The economy's geographic imprint.**
- **Some books to consider.**

The Second Half Will be Better

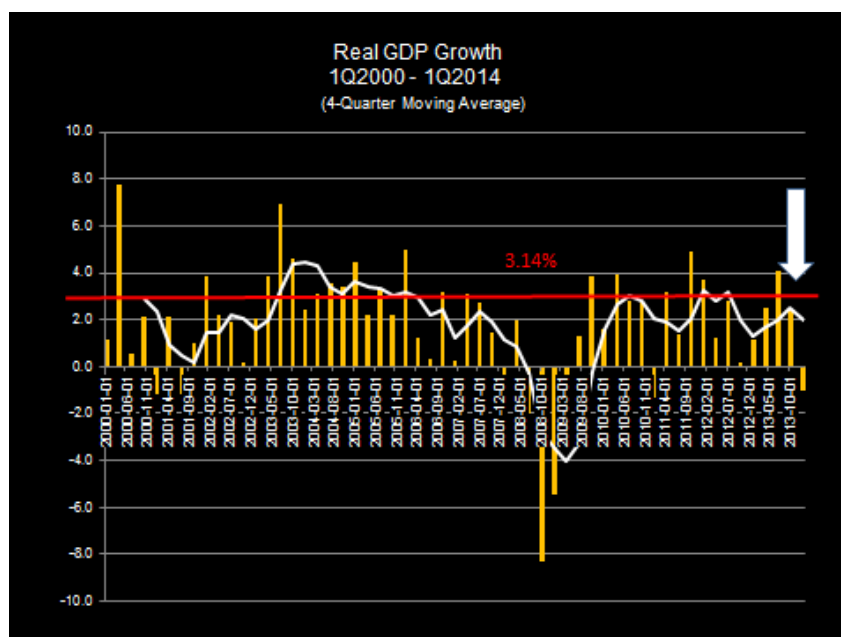
Consider the bad news first

Have you ever had a car break down just as you felt you were beginning to get somewhere? And had to get out and hitch hike, hoofing it while hoping for a ride? If so, you know what it's like to have your speed reduced to a crawl, and to be hoping for a better ride.

That's the current situation with the economy.

When the second estimate for 1Q2014 real GDP came in with minus 1.0% growth, one thing was clear: the winter of 2013-14 was really rough. Snow-bound cities, disrupted rail yards, and people stranded on interstate highways for hours do not produce GDP. As shown below, the weak first quarter data broadened the gap between where we are and where we would like to be (the 3.14% long-run growth rate), and pulled the 4-quarter moving average down to 2.0%. It will take some very strong late-year quarters to generate a 2.3% to 2.5% annual growth.

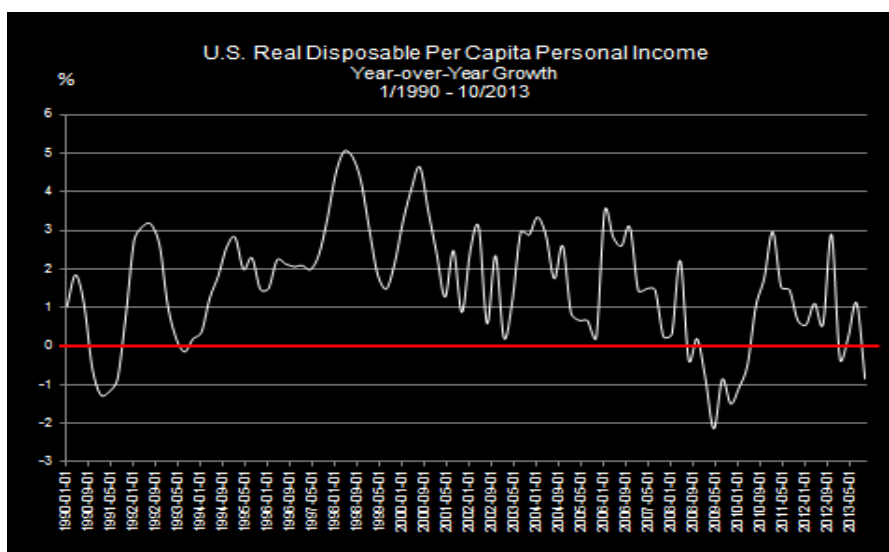




This is not the kind of stuff that helps fulfill the American dream.

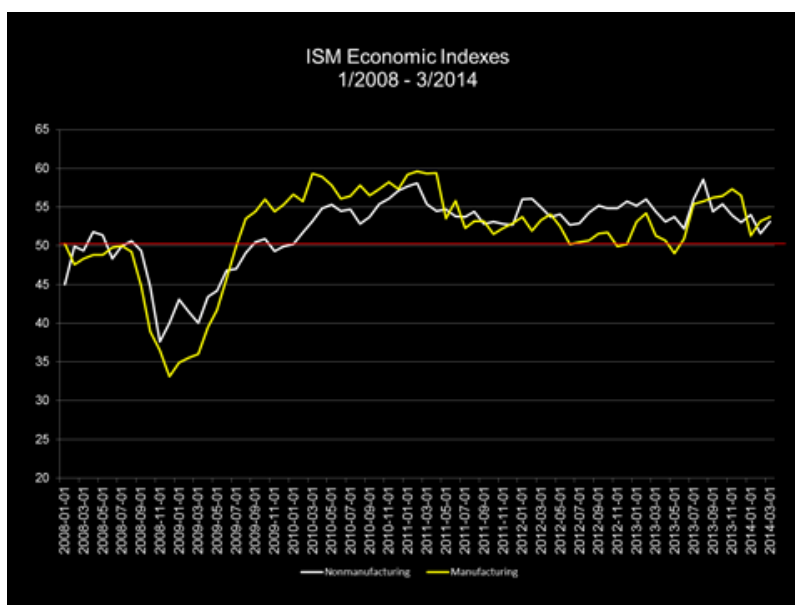
Blame it on a horrible winter or something else, the Great American Bread Machine is not producing much bread.

Confirmation is seen in the most recent data on growth in real per capita disposable income, the average amount Americans earn in after-tax spending money. The latest estimate arrived in negative territory. Pale GDP growth and higher taxes have put the American people in the cellar, at least in terms of earned income. Unfortunately, the data points shown below have taken a decidedly negative slope from 1998 forward. Pensions, welfare benefits, and unemployment compensation, which are included in disposable income, provide some relief, but also add to the deficit.

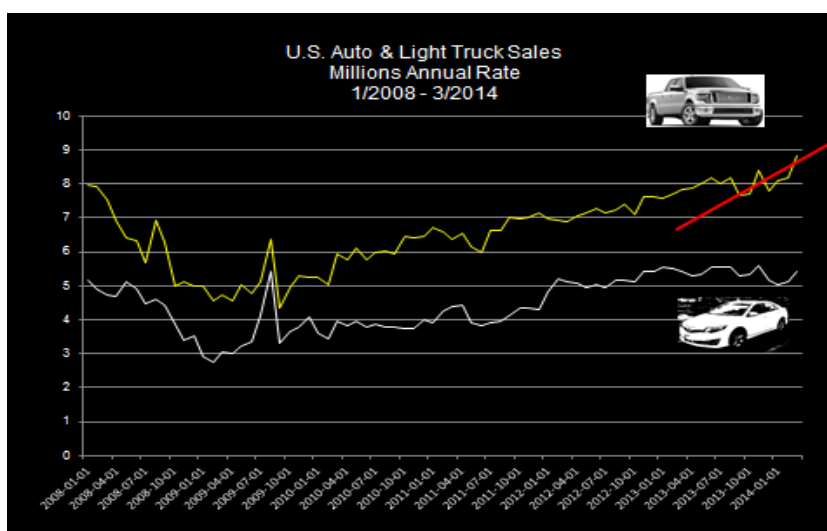


Looking forward to a better ending

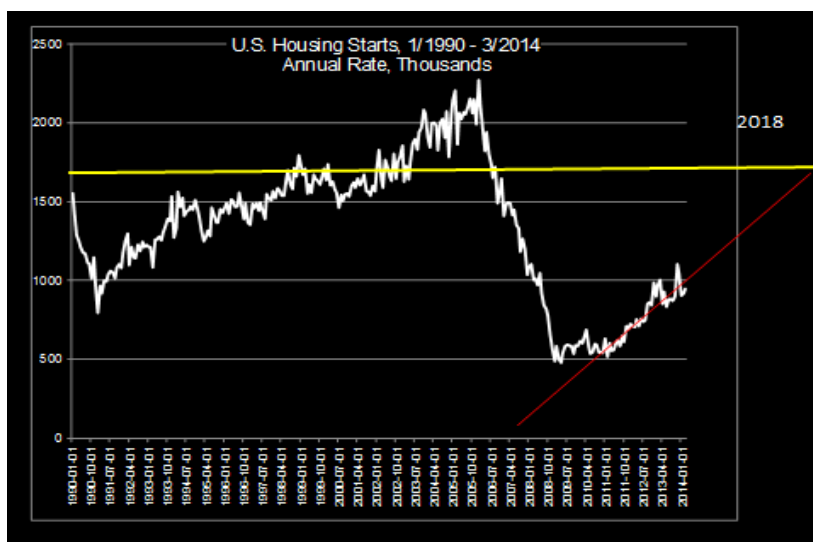
In spite of all this, I am optimistic about the year's last half. Here's why. Let's start with the good news seen in the Institute of Supply Chain Management's (ISM's) manufacturing and nonmanufacturing indicators. As shown next, while riding a bumpy path, both indices, with values greater than 50, have been calling for an expanding economy for months.



If ISM indicators don't make your heart go pitter-patter, consider my pick-up truck indicator. Booming pick-up truck sales are a sign of a recovering construction sector as well as better days in the goods-producing sector. Things are looking a lot brighter on the truck front.



Well if those trucks are heading to construction sites, what about housing start data? Are we about to be out of the woods? The next chart tells us that housing starts are accelerating. By 2018, we should be back on the pre-crash yellow brick road. But this isn't Kansas, Toto. Getting back to where we were almost seven years ago is not exactly the same as boom times.



If ISM indicators, trucks sales and happy construction data are not enough to put a smile on your face, then what about the most infallible indicator of coming prosperity of all? The hem-line of lady's dresses?

Word has just arrived from the fashion mavens that the mini-skirt is back. And that means better times are on the way. I show below a collection of past and present hem-length data. The longer the skirts, the tougher the times. To get the point, take a look at the hem-length for the 1980s, which is really for the 1983 recession, the most severe in history till the Great Recession came along. Dragging the ground!

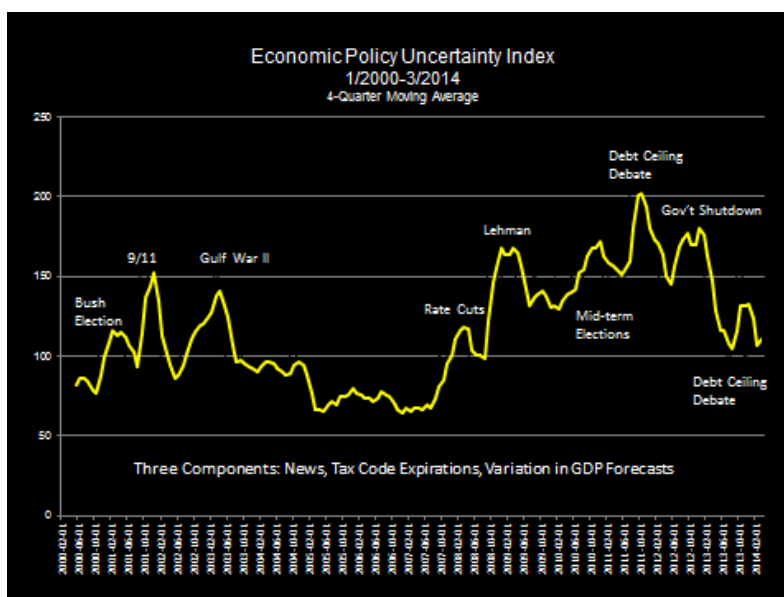


It's my guess that the 2014 high hems will square with 3% real GDP growth in the second half of the year. So bring 'em on.

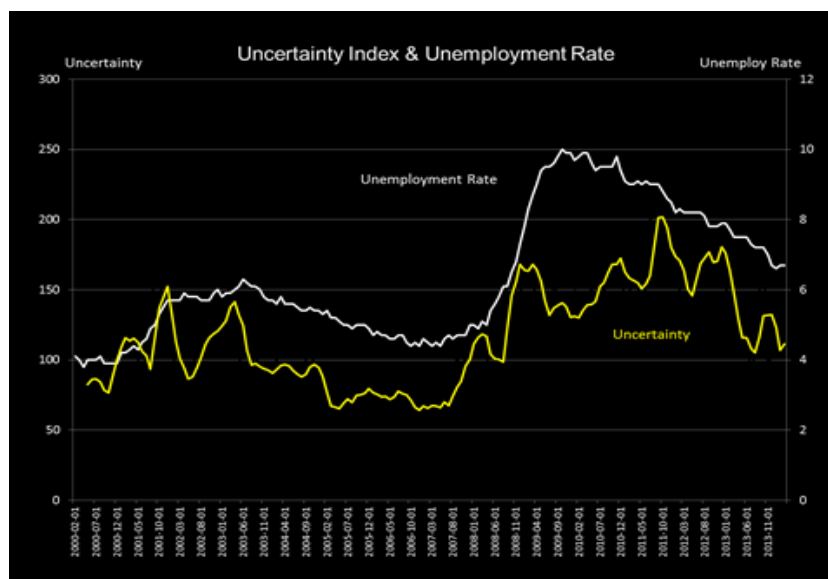
What Will Government Do?

Yes, some reliable indicators are pointing north, but there's a lot of uncertainty plaguing the economy. And clouds of uncertainty cause investors to require higher rates of return before launching major new investments or making new hires.

An index of policy uncertainty maintained by economics faculty members at the University of Chicago and Stanford offers some insight here. The index has three components: a news analysis, revisions in tax codes, and dispersions in GDP forecasts. The next chart shows the index for the last 14 years with notes associated with peaks and valleys. As indicated, when George W. Bush's election decision went to the Supreme Court, the index jumped a bit, but not by nearly as much as on 9/11 or the opening of the Gulf War. Since 2008, the index has performed a jagged dance skyward and then receded. It's the current trend that interests us most, and it is looking better.



I mapped the unemployment rate into the uncertainty index in the next chart. Notice first that the mapping works fairly well. Then, note that both series are headed south. No, the happy norms of the past are not quite breeched, but things are surely looking better.



The key take-away is this: Economic uncertainty is falling. All else equal, more confident employers will hire more workers. Other indicators tell us that construction is picking up. Put it together and we get a stronger second half, perhaps to crank enough GDP growth to yield 2.3% for the year.

But wait a minute, what about inflation and the Fed's money tree?

Will the Second Half Bring Inflation & Higher Interest Rates?

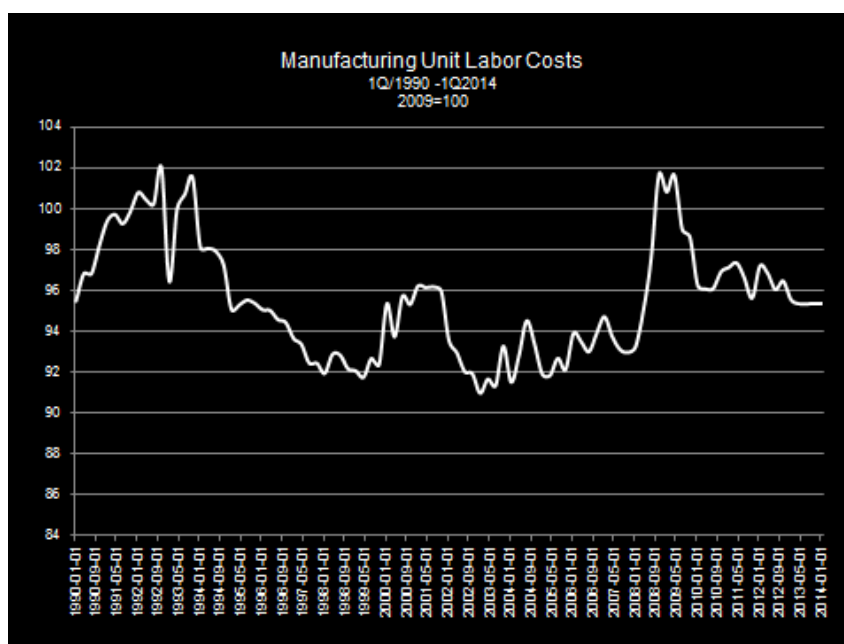
I have been concerned about the inflation prospects for years. But it hasn't happened yet. My concern is based on the fact that the major ingredient for future inflation is in place; there are huge amounts of excess reserves in the banking system. Those reserves can quickly become money in the economy when bank lending picks up.

The old equation of exchange tells us that $MV=PQ$, which is a short-hand way of saying that the amount of money circulating in the economy multiplied by velocity—the rate at which the money moves—explains the level of nominal GDP. P in the equation stands for the price level; Q the amount of real goods and services produced. Sooner or later, the equation tells us, a higher M will lead to a higher P , if Q and V are relatively constant. Rapid increases in potential M , such as experienced since the crash, must—the argument goes—lead to inflation. After all the level of production just doesn't grow very fast. Indeed, output is hardly growing at all right now.

So what about inflation? And higher long-term interest rates that tend to rise uniformly with higher inflation?

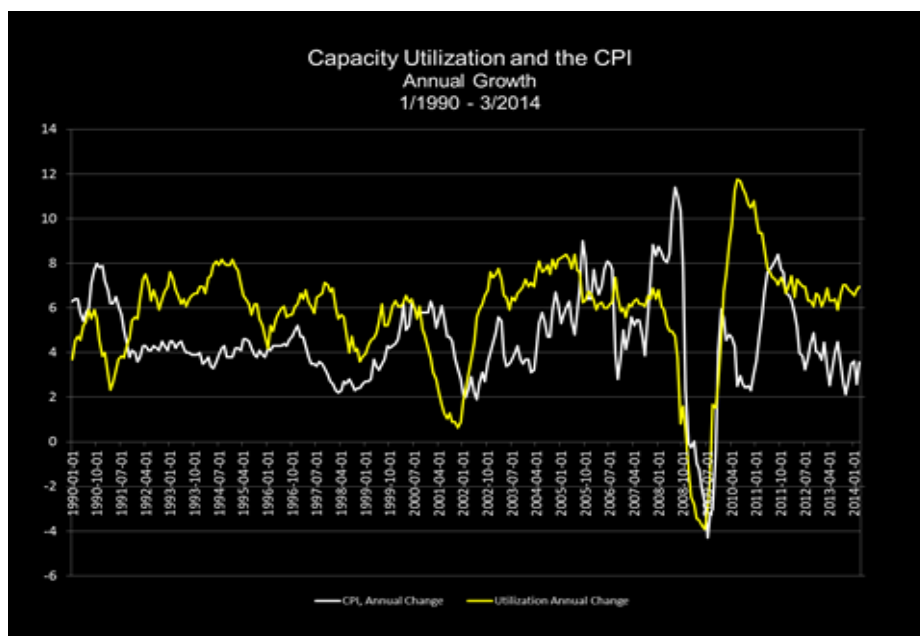
Looking at Labor Cost Data and Capacity Utilization

To make a first swing at the questions, I examined unit labor cost data—an index that measures the cost of labor contained in one unit of national output—to see if there are meaningful increases showing up in the quarterly time series. I report the data below, noting that the index seems to be behaving in a tame fashion.



To get a second handle on the problem, I looked at data on capacity utilization for the economy. After all, if there is a lot of slack in the economy—unused capacity—then the unused capacity will help cushion inflationary effects that could be generated by expanding consumer demand. Put another way, output can rise without putting pressure on production and costs. I then mapped growth in capacity utilization into the growth rate of the consumer price index, the CPI, which is my proxy for inflation.

The results are shown in the next chart.



As indicated, growth in the CPI follows capacity utilization growth fairly closely. First, capacity utilization growth increases; then the CPI takes off. What do we see in the current period? Capacity utilization growth is rising a bit. Growth of the CPI is headed south, but at a very slow pace. For the most recent 12 months, the CPI has moved up 2.0%. The growth rate of inflation is weak, but the growth rate of capacity utilization is rising.

What can we make of this? The data suggest that if capacity utilization growth continues, pressure will be placed on the CPI. The pressure will be accommodated by the large amount of bank reserves waiting to enter the economy. When the gears of $MV = PQ$ begin to mesh, we will see higher inflation and higher interest rates.

But when? What do the data suggest? And what about Fed policy?

The data suggest we are in low interest territory for the rest of 2014, but that we will begin to see higher interest rates in the year ahead. But how high? The data don't give a basis for answering that question, but I would suggest that we are looking at a 60 to 70 basis point increase in the 10-year bond rate over the next 12 months.

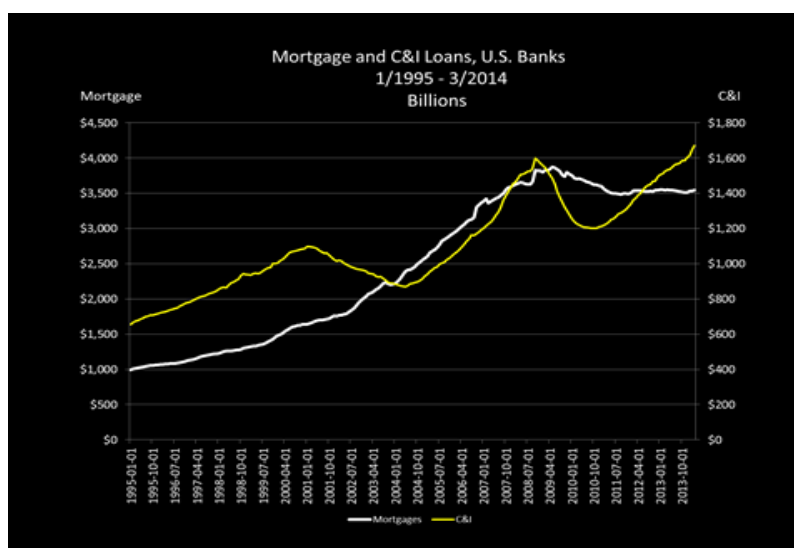
The 10-year Treasury note was yielding 2.66% in late May. With 70 basis points added, the yield should rise to 3.36% by June 2015.

Will that put the economy in the cooler? Hardly. Real GDP growth should be moving at a 3.0% pace in early 2015.

Bank Lending is the Transmission

Remember, bank lending is the transmission in the money machine. Increased lending means more money moving through the economy. Does lending activity support the notion that the economy is getting on its feet? Let's take a look.

The next chart shows bank lending nationwide for commercial and industrial (C&I) and mortgage loans. Yes, the pace is picking up handily for C&I loans, but not for mortgages. This should be changing soon.



In mid-May, the Obama administration announced that FNMA and GNMA, the government-owned backstop for 90% of the mortgages made in America, were being instructed to relax some of the more stringent requirements for mortgages purchased for their securitization programs. The reason? The belief that the economy will not get on its feet until housing markets are cranking again. With down-payment requirements slated to fall, we should see some higher mortgage lending activity in the near future.

But does this opening of the money faucet mean that we are again building future economic prosperity on a foundation of sand? Will we see a repeat of the George W. Bush and William Clinton efforts to make homes affordable for all Americans, even those who cannot make their monthly payments? And see the affordable home effort convert to a sub-prime crisis?

It is too soon to say. But as Mark Twain put it: "History doesn't repeat itself, but it does rhyme."

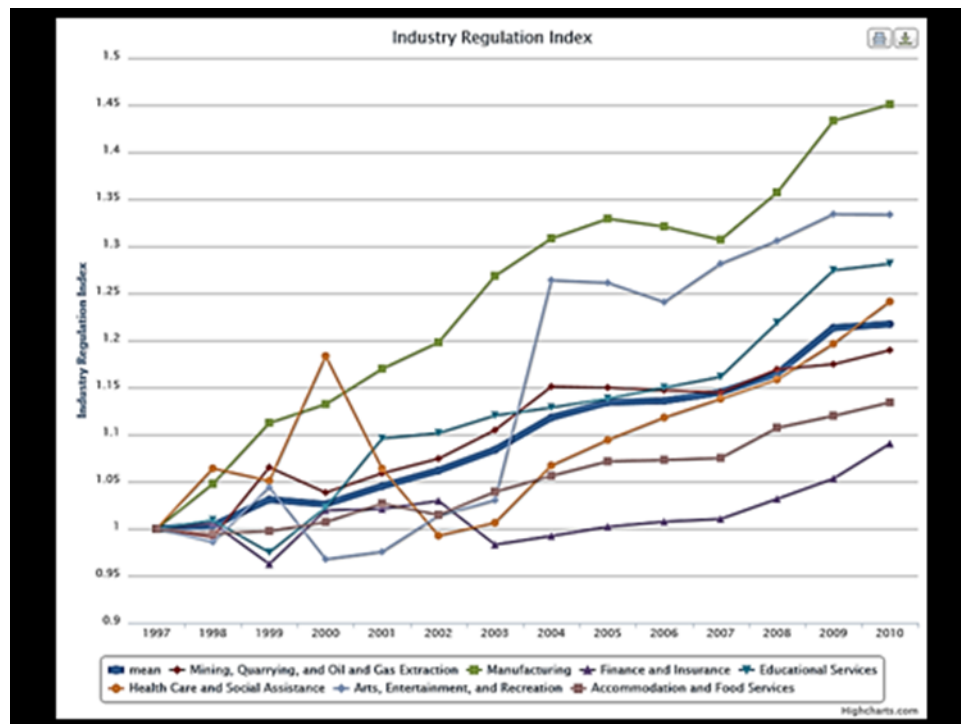
The Regulatory Imprint

We live in a cyclical world. Things improve, reach a strong pace and then recede. Mostly due to government policy. When things are moving up and down, investors and consumers have to react, to adjust, and revise their plans. In doing so, the performance and responsiveness of the economy is affected by all kinds of internal and external constraints, including regulation. Too many bones; too little flexibility.

I have just mentioned how the change in a federal mortgage lending rule may have an impact on the future growth on housing starts and bank lending. That's just the action of one regulatory agency. There are more than a hundred regulatory agencies and millions of rules that form an imprint on the economy.

The next chart draws on data produced by George Mason University's RegData program. RegData can be used to form an index based on the frequency of the occurrence of certain words counted in the Code of Federal Regulation, the multi-volume compendium of all federal rules currently in force in the economy. The words are: Must, Required, May not, and Prohibited. These words are part of the vocabulary of command-and-control regulation. They form constraints that affect the ability of firms and industry to respond to changing economic circumstances.

The chart shows the index for a sample of industries and the all-industry average for the years 1997 through 2010. The index has an initial 1997 value of 100. Note that manufacturing has experienced a 40% increase in the occurrence of the restraining words. Also, note the all-industry average has risen about 25%. But consider the sizable increase for educational services and arts and entertainment. These are becoming highly regulated sectors.

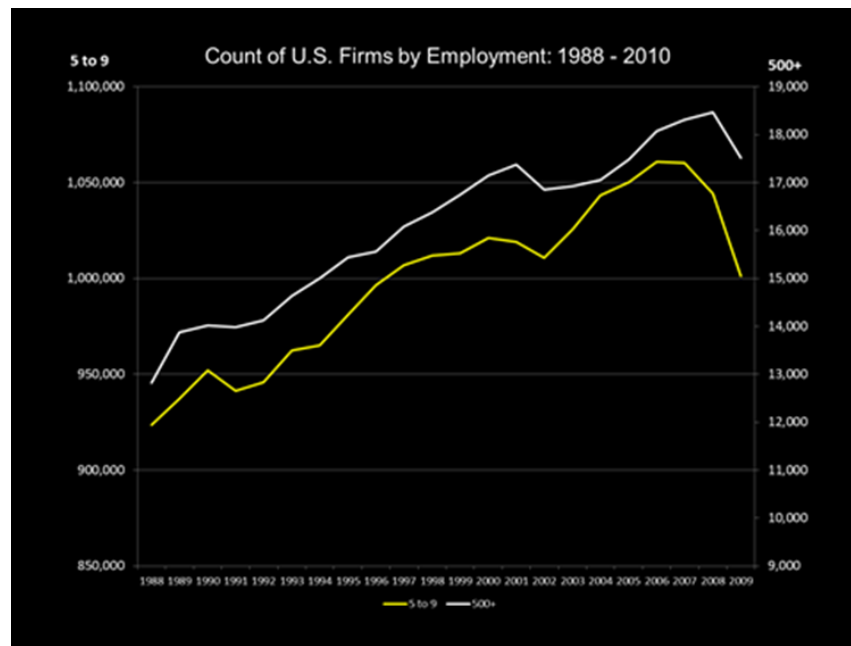


How might all these rules affect the economy's performance? By my count, some 30% of the labor force is now employed in highly regulated sectors of the economy, such as health-care, banking, insurance, mortgage processing, energy, and education. Most of the noted industries are in the services sector where international competition doesn't matter as much as in the goods sector. Regulation reduces what might already be weaker innovation and competitiveness, and that in turn reduces entry and exit of firms.

Within all industries, regulation is generally more burdensome for smaller than larger firms. There is a fixed cost component to regulation that must be paid by small and large alike, and larger firms have more production for spreading regulation's cost.

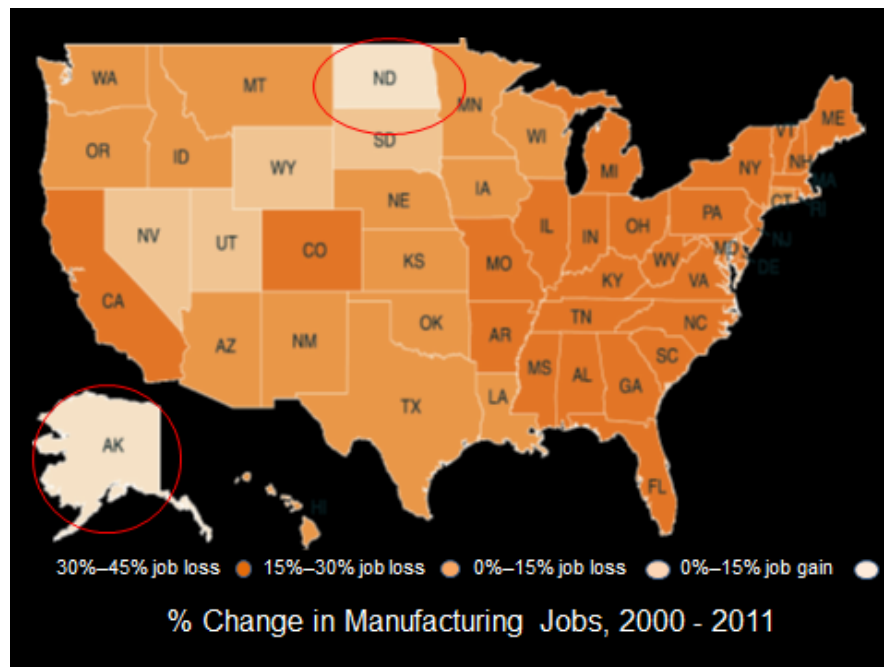
These regulatory forces affect the size distribution of firms in the economy, the relative number of small and larger firms. This is shown for two size categories in the next chart for the years 1988 – 2010. Notice first that the number of larger and smaller firms fell during the recession, but that the smaller category began to decline in 2005. Notice, too, that the count of smaller firms is now at the 1995 level.

Smaller firms form the burgeoning part of the economy, the part that produces jobs. While charts do not determine cause and effect, the data coupled with common sense support the hypothesis that regulation is holding us back.

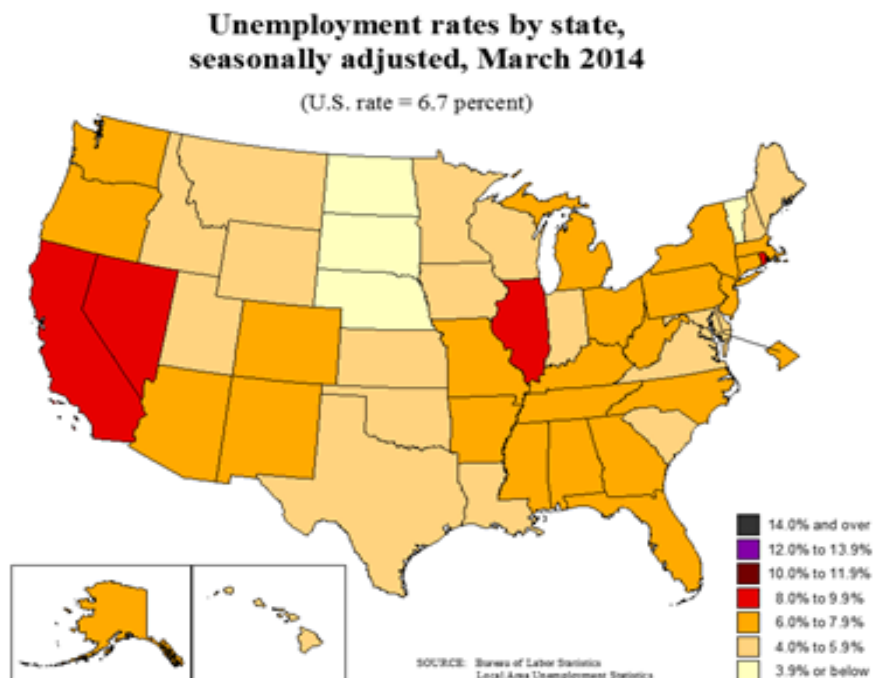


The Geographic Imprint

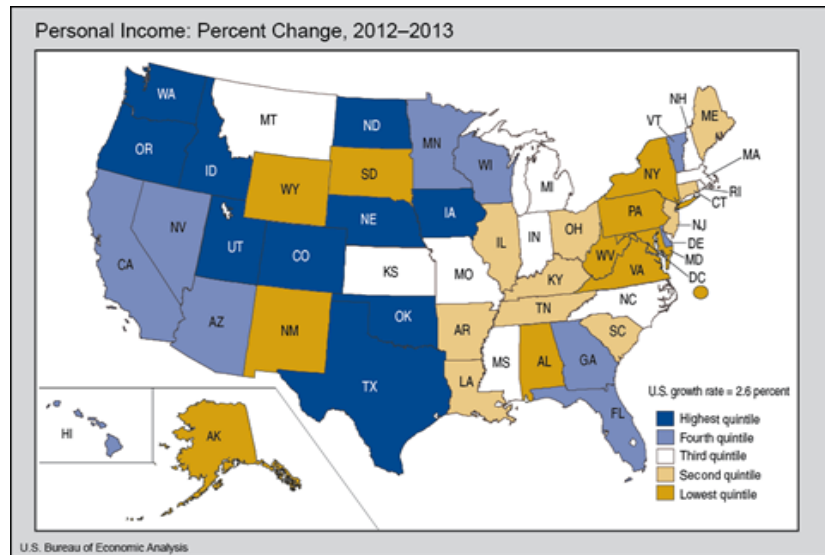
The results of economic activity get registered in state data, and with remarkable variation. Consider the shift in employment from manufacturing to services that has occurred over the last decade or so. As shown below, only two of the 50 states show an increase in manufacturing employment—North Dakota and Alaska—and for reasons summed up in one word: energy. Manufacturing employment has fallen precipitously in states east of the Mississippi River, where manufacturing activity was concentrated.



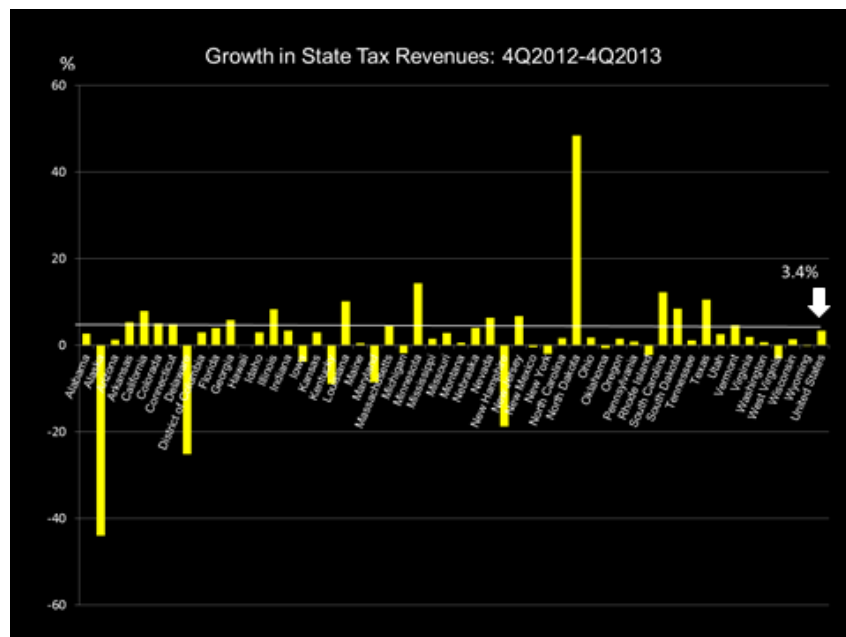
Labor market adjustments accompanying the shift left a pattern of unemployment rates that reflects the depth of the adjustment. Even now, as shown next, the older manufacturing states in the east are still in transition



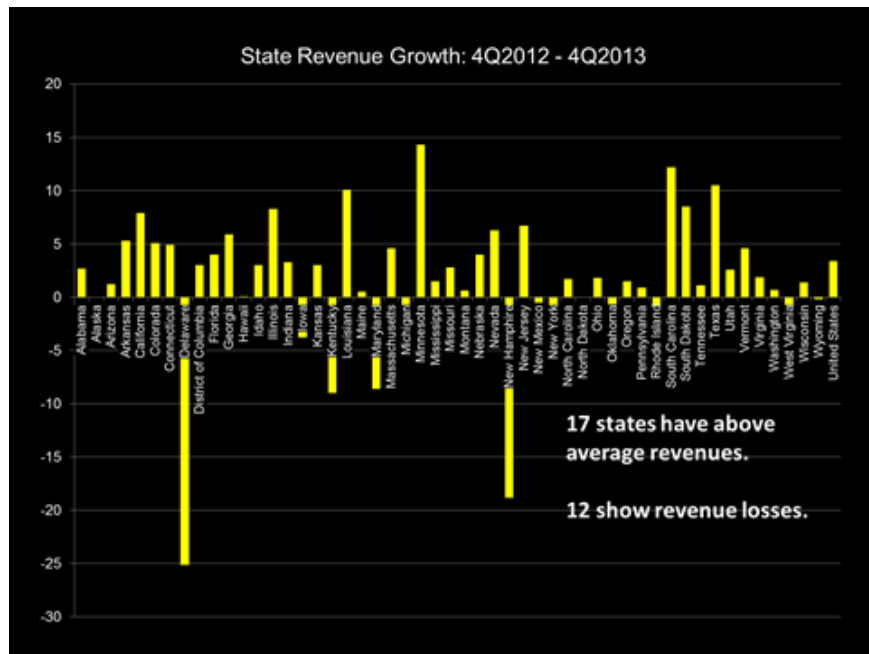
Slower employment growth yields a predictable variation in total personal income growth. As shown next, the energy and hard grain states have fared far better than the heavy manufacturing states.



Variations in personal income growth then lead to variations in state revenue growth for a recent 12-month period, as shown in the next two charts. The first revenue growth chart contains two outliers—North Dakota and Alaska. Yes, shale oil and fracking does yield revenue for new ground producers, and the resulting lower prices lead to revenue losses for older producers.



With the two outliers removed, it is easier to see the relative gains and losses of the remaining states. As shown here, 17 states have revenue growth that is paler than the all-state average. Twelve states show revenue losses for the year.



Books You May Enjoy Reading

Thomas Piketty's *Capital in the Twenty-First Century* is the economics book of the hour, if not the year or longer. This 577-page work, not counting footnotes, is a powerfully impressive display of scholarship and creativity. Focusing on three centuries of the history of wealth, income, and resulting inequalities, Piketty creatively uses descriptions of society and life found in Jane Austen's and Honore' de Balzac's novels as important evidence to support his claims about wealth and social structure. I must admit that I am still working with the book, having made my first pass-through a few days ago. The book is unique, I would say, in that it might be described as an accountant's interpretation of macroeconomic activity in the Western world. I say this because of the attention paid throughout to national balance sheets and income statements. There is plenty to like and to question in a book of such scope and multi-country treatment. I admire a lot of the scholarship, but I am very uncomfortable with what I would term rather sweeping policy conclusions the author makes. Radical taxation policy proposals—recognized as such by the author—are offered with the claim that they would beneficially address inequality in wealth. But saying this is not meant to imply that *Capital* should not be studied carefully, discussed broadly, and admired as an impressive piece of scholarship.

I count myself lucky to have been a part of a monthly book discussion group for several decades. I get to read and enter discussions with good friends and colleagues who are passionate about economics. We recently worked through *The Second Machine Age* by MIT professors Erik Brynjolfsson and Andrew McAfee. I rank this book one of the most important works in its category in the last 10 years. Well written and documented, the book is driven by the notion of exponential growth triggered by such things as the latest smart phone technology. Connectivity that can spur innovation, boost interaction with smart robots, and bring human flourishing is a key element of the story.

The book is a powerful antidote to the pronounced pessimism generated by a typical scan of the evening news. Read this one and smile. Better yet, buy a copy for a young friend who is trying to figure it all out while fingering the very machine that is defining our future.

Not all my reading is driven by book club discussions. I recently enjoyed reading *Chasing the American Dream*, authored by sociologists Mark Robert Rank, Thomas A. Hirschl, and Kirk A. Foster. Beautifully written and strongly documented, the book combines the results of an effort to define the American dream based on interviews and panel discussions with heavy empirical documentation of what is happening in the chase. The reported conversations with a broad cross section of people—rich, poor, professionals, and otherwise—were to me the most interesting part of the book.

On the basis of the interviews and other survey data, we learn that commonly held components of the dream include being free to pursue your passion, being able to earn a living from your work, if you work hard, to have a home, and to be able to provide for your family. It's not about becoming extraordinarily rich, but about becoming extraordinarily happy. As might be expected, we learn that a lot of dreams were crushed by the Great Recession, the jobless recovery, foreclosures, and unemployment.

To the authors' credit, the book does not leave the reader feeling downhearted at the end. Just the reverse, I was left with a feeling of keener appreciation of the beauty of the dream and wondering to what extent most people do dream optimistically about their future.

Making a Mid-Year Assessment

As much as I hate to do it, I must assess where we are now with where I said we would be in December when I offered projections for the year ahead. Here's the statement from December's Situation report. Wouldn't you know? The very first sentence is a loser. The 0.1% estimate for 1Q2014's GDP growth killed that forecast. But while near dead and kicking, the economy will continue to move on a 2.0% to 3.0% path. Yes, retail sales and housing are recovering apace.

2013-14 U.S. Outlook

The Nation

- Quarterly GDP growth will range from 2.0% to 3.0% across 2013 and 2014.
- Wealth is being created. Retail sales are recovered and rising. Housing is recovering.
- The unemployment rate will stay in the 6.5% to 7.5% range.
- Inflation will range 1.5%-2.0%.
- Interest rates will be on the rise as the Fed gently tapers. 20-year bond, recently 3.72% before falling again, will hit 4.10%.
- Energy prices will remain flat, if not lower.

Hazards or ghosts from the past that may disturb the outlook.

- If rapid, Fed unwinding of massive excess reserve position poses serious risk for interest rate run-up and decline in equity prices, which will in turn produce negative wealth effects.
- A huge deficit that must be dealt with. Taxes? Cut spending? Print money?

What about unemployment? I called for a range of 6.5% to 7.5%. The unemployment rate is now 6.3%, and will likely trend lower. Of course, most of the gain is associated with people leaving the workforce. No excuses. I missed that one by 0.2 percentage points! As they say, "Close counts in horseshoes." What about the inflation rate? Thank heavens! I finally have a ringer. Inflation is running right at 2.0% as I write this. Now comes the really bad one. The 20-year bond yield fell in the first half of this year and in late May sat at 3.21%. I don't look for 4.10% any time soon. Yes, energy prices have been tame, and should continue to follow that path.

What would you call it? A "gentlemen's C"?

What about the next 12 months?

I expect real GDP growth to stay in the 2.5% to 3.0% range and unemployment to stay close to the current 6.3% level. I expect inflation to increase from the current 2% to 2.3% by mid-2015, and the yield on the 20-year Treasury to move toward 3.60% in the same period.